United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

74-1617

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

ESTATE OF DAVID SMITH, Deceased,
IRA M. LOWE, CLEMENT GREENBERG,
ROBERT MOTHERWELL, Co-executors,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court correctly decided that, in computing the value of the gross estate for purposes of the federal estate tax provisions, taxpayers [1/] are entitled to deduct as administration expenses the amount of commissions paid to an art dealer on the sale of sculpture only to the extent that such sales were necessary in order to pay the decedent's debts, the expenses of administration, and taxes under Section 2053 of the Internal Revenue Code of 1954 and the Regulations thereunder.

1/ References to "taxpayers" are to Ira M. Lowe, Clement Greenberg, and Robert Motherwell, co-executors of the Estate of David Smith.

STATEMENT OF THE CASE

This is an appeal by taxpayers from a decision of the Tax Court entered on January 30, 1974. (R. 100a.)[2/] That decision determined a deficiency in estate tax of $71,433.51. The findings of fact and opinion of the Tax Court (R. 72a-90a) (the Honorable Theodore Tannenwald, Jr.), filed on February 23, 1972 (R. 2a, 72a), are reported at 57 T.C. 650. Timely notice of appeal was filed by taxpayers on April 25, 1974. (R. 3a, 101a.) The jurisdiction of this Court is invoked under Section 7482 of the Internal Revenue Code of 1954.

The relevant facts of this case, as found by the Tax Court, may be summarized as follows:

The decedent, David Smith, died from injuries sustained in an automobile accident on May 23, 1965. At the time of his death, Smith owned 425 pieces of sculpture which he had created during various periods of his life. Most of his work is of the abstract, nonrepresentational variety and fashioned out of welded steel and other metals. (R. 72a, 73a.)

On or about June 2, 1963, Smith entered into an agreement with Marlborough-Gerson Galleries (Marlborough) which provided, *inter alia*, that Marlborough would be the exclusive sales agent for Smith's work for a period of five years and would receive commissions on any such sales in the amount of one-third of the net sales price. The agreement further provided that it was to be binding on the respective executors, administrators, successors,

2/ "R." references are to the separately bound record appendix.

and assigns of the parties. This contract was renewed by Smith's estate on June 3, 1968. (R. 73a-74a.)

Smith died testate. (R. 77a.) His will was admitted to probate by the Surrogate Court in Warren County, New York. (R. 12a.) Ira M. Lowe, Clement Greenberg, and Robert Motherwell qualified as co-executors of the estate. (R. 72a.) Decedent's will, in pertinent part, provided as follows (R. 22a-25a):

> FIRST: I order and direct my Executors hereinafter named, to pay all of my just debts and funeral expenses as soon after my death as may be practicable. I also direct my Executors to pay all inheritance and estate taxes, and all other governmental charges, taxes or liens upon my estate passing under the terms of this my last will and testament * * *
>
> SECOND: I hereby give, devise and bequeath all the remainder of my property including real and personal and all works of art including sculpture, paintings, drawings and any and all other forms of art of which I die possessed or which I may own or have any interest in at the time of my death to the Trustees, hereinbelow designated, IN TRUST NEVERTHELESS FOR THE FOLLOWING USES AND PURPOSES:
>
> To divide the same into two separate and equal parts or shares, one for each of my children, Rebecca and Candida, and the Trustees shall hold one of the said parts or shares as a separate trust for each of said children.
>
> The Trustees shall have the power to apply any part of the principal and income of the estate held in trust for each child to her support, education, and maintenance * * *

* * *

THIRD: My Executors and Trustees shall take possession of my estate and are hereby given power to hold, manage, operate, control, sell, convey, lease, mortgage, encumber, renew encumbrances, and assign the said estate, or any part thereof, to collect all the rents, income and profits therefrom; to pay all taxes, insurance charges, necessary repairs and other proper expenses connected therewith; and with full power to sell and convey, from time to time, and to mortgage and encumber such parts of my property and estate, real or personal, including all of my works of art, as in their best judgment and discretion may be expedient. The proceeds derived from any such sale or sales shall be invested and reinvested from time to time in such securities and property, real or personal, as my Trustees may elect.

In the disposal of my works of art and other property, real and personal, said Trustees shall have as full and unlimited power and discretion as if said trust property were their own absolute estate.

*   *   *

SEVENTH: I hereby nominate, constitute, and appoint Robert Motherwell, Clement Greenberg, and Ira M. Lowe to be my Executors and Trustees under this Will * * *

*   *   *

At the time the Tax Court delivered its opinion in this case, the co-executors had not filed a final accounting of the estate with the New York Surrogate's Court. (R. 78a.) Two intermediate accountings had been filed covering the periods May 23, 1965, to April 30, 1968 (Ex. 19-S, No. 1), and May 1, 1968, to April 30, 1970 (Ex. 19-S, No. 2), which were approved by the Surrogate's Court. In each of these accountings, sales of sculpture were listed in the respective Schedules A-1, stating the date of each sale and the amount received. In the respective Schedules J of each of these accountings, it was explained that the amounts stated as received with respect to the sales of sculpture in the respective Schedules A-1 were net of the commissions charged by Marlborough. For the periods covered by these two accountings, such commissions aggregated $1,187,144.67. (R. 78a.)

From May 23, 1965, through April 30, 1970, the estate was required to pay $789,970.38 for various administration expenses, debts of the decedent, and taxes, of which amount $364,556.37 3/ was allowable as a deduction under Section 2053 of the Internal Revenue Code of 1954. At the time of decedent's death, total cash available to the estate from sources other than the sale of sculpture amounted to $210,647.08. $868,984.94 worth of sculpture was sold through Marlborough to cover the difference between the

3/ The figure $390,481.20 appearing in the appendix at pages 78a and 90a is incorrect. See Order of the Tax Court dated January 24, 1974.

enumerated expenses and ready cash, or $579,323.30. Commission expenses of $289,661.65 were incurred in respect of such sales. (R. 78a.)

In addition, the executors paid $55,937.75 to the decedent's widow for the support of the two minor children. The executors have also made payments totalling $1,392,491.69 to the trusts created under decedent's will for the benefit of those children. (R. 78a.)

A federal estate tax return was filed with respect to the Estate of David Smith on August 24, 1966. (R. 72a.) The co-executors reported the date-of-death value of the sculpture included in the estate as $714,000. (R. 77a.) They also claimed a deduction for all commission expenses incurred with respect to the sale of the sculpture. (R. 78a.) Upon audit, the Commissioner determined that the value of the sculpture at the time of Smith's death was $5,256,918 (later abated to $4,284,000) (R. 79a) and disallowed any deduction for commission expenses in excess of $289,661.65 (R. 78a). A deficiency of $2,444,629.17 was assessed accordingly. (R. 72a.)

Upon petition for redetermination (R. 4a-9a, 11a), the Tax Court (in a reviewed opinion, five judges dissenting as to the issue now on appeal) determined the date-of-death value of the 425 pieces of sculpture to have been $2,700,000 (R. 79a). The Tax Court also determined that taxpayers were entitled to deduct commissions on the sale of sculpture as administration expenses only to the extent that such sales were necessary to raise enough cash to pay the debts of the decedent, other administration expenses,

and taxes (including the deficiency), to the extent that other funds were not available to make such payments. (R. 90a.) 4/ Decision was ultimately entered in the Commissioner's favor in the amount of $71,433.51. (R. 100a.) Taxpayers appeal from that portion of the Tax Court's decision which denied a deduction for commission expenses beyond that which was allowed. (R. 101a.)

SUMMARY OF ARGUMENT

Section 2053(a) of the Internal Revenue Code of 1954 allows a deduction, in computing the estate subject to tax, for "administration expenses * * * as are allowable by the laws of the jurisdiction * * * under which the estate is being administered." The Treasury Regulations defining the term "administration expenses" generally limit the deduction to expenses necessarily incurred in the proper settlement of the estate. The expenses of selling the property of the estate are dealt with specifically by these Regulations; such expenses are not deductible unless the sale is necessary to pay the debts of the decedent, administration expenses, or taxes, to preserve the estate, or to effect distribution. The Tax Court, applying these Regulations to the sales of sculpture in

4/ Ultimately, the Tax Court allowed the estate a deduction for commissions paid on the sale of sculpture in the total amount of $759,447.74: $289,661.65, representing the amount of commissions on sales of sculpture necessary to realize $579,323.30 (the difference between expenditures paid by the executors between May 23, 1965, and April 30, 1970, and ready cash), $410,012.52, representing the amount of commissions on sales of sculpture necessary to realize $671,452.93 (additional administration expenses incurred by the executors from May 1, 1970, to August 14, 1973), and $50,773.57, representing the amount of commissions on sales of sculpture necessary to realize $71,433.51 (the New York and federal estate tax deficiencies resulting from the Rule 50 computation). (R. 78a, 98a, Schedules 1B, 1C.)

this case, allowed taxpayers a deduction for sales commissions to the extent such sales were necessary to pay debts, expenses, and taxes, but disallowed a deduction with respect to any additional sales. Taxpayers challenge this determination on three grounds, all of which are unmeritorious and should be rejected.

First, taxpayers argue that the Tax Court misapplied the Regulations in this case, contending that the additional sales of sculpture were necessary either to preserve the estate or to pay taxes. This argument is not supported by the facts and should be rejected. Decedent's will contemplated a distribution in kind of the sculpture to the testamentary trusts. Although the executors had a power of sale, that power was limited to sales necessary to fulfill their obligations as executors under the will; that is, to pay debts, expenses, and taxes. Sales beyond these were made on behalf of the trusts, and hence the expenses of such sales are not deductible. Moreover, there was no danger of an imminent decline in the value of the sculpture; the evidence indicated exactly the opposite.

Taxpayers' contention that deduction of sales commissions as an administrative expense is justified as being in anticipation of additional tax deficiencies if the Commissioner were to prevail on his contention that the sculpture had been undervalued is erroneous. The facts show that the executors distributed substantial sums of money to the trusts before the estate was closed for tax purposes, that they actively contested the valuation issue until the Tax Court set a value midway between the amounts asserted by the two parties, and that there was a ready market for the sculpture. Under these circumstances, the Tax Court's finding that additional sales of

sculpture were not necessary is well supported by the record in this case.

Taxpayers' second argument is that the standards for allowing an administration expense are the same under both New York probate law and the federal Regulations; therefore, the Tax Court was without authority to re-examine an expense which had been allowed by the state probate court. This contention is erroneous both in its essential premise and in its conclusion. The federal regulation is specific: A selling expense is deductible only if the sale is made by the estate and necessary to pay debts, expenses, or taxes, to preserve the estate, or to effect distribution. New York law, on the other hand, allows the surrogate to approve sales under a wide variety of circumstances, including sales made by a trustee on behalf of the trust. The surrogate is required to approve accountings wherein the only error is that the executor-trustee took a contested action in the wrong capacity. In addition, the New York law delineating the functions of executor and trustee, when the same individual serves in both capacities, supports the Tax Court's resolution of this issue: The executor can make sales only to the extent necessary to pay debts and legacies, additional sales being made in his capacity as trustee. Thus, it cannot be said that the standards for allowing an expense are the same under both New York and federal law. Moreover, even if the standards were the same, the Tax Court would still not be precluded from making an independent review of the facts in the light of federal law. Cf. Commissioner v. Estate of Bosch, 387 U.S. 456 (1967).

Finally, taxpayers argue that if the Regulations are interpreted to deny a deduction for an expense which has been allowed by the state probate court, the Regulations are invalid. Again, taxpayers have misconstrued the law. Section 2053 is separable into two parts: (1) The expense must be an "administration expense," and (2) it must be "allowable" by the laws of the probate jurisdiction. These Regulations, which are restatements of prior Regulations dating back to 1919, provide a definition of what an "administration expense" is, under the first part of this statute. Congress considered this prior law in enacting Section 2053 in 1954, and approved prior law dealing with the deductibility of administration expenses, of which the Commissioner's Regulations were a part. Not only do Regulations of such long-standing as these have the force of law, but to be declared invalid, they must be found to be unreasonable and plainly inconsistent with the statute. Taxpayers do not contend that these Regulations are unreasonable, nor does it appear that a credible argument to that effect could be made. Rather, taxpayers urge a construction of Section 2053(a) which would give the state probate court the authority to determine not only what is "allowable" under its own law but also what is an "administration expense" under federal law. Such is not the law. As discussed above, the state probate court may allow an expense on grounds totally unrelated to the interests of the federal revenue. Indeed, many states, including New York, allow items of expense which are clearly not deductible under the federal statute. In addition, such a construction runs counter to the elementary principle that federal law determines the taxability of state-

created interests regardless of the label such interest may be given under state law. Likewise with deductions, state law may label an item an "administration expense," but federal law must determine if the particular item is of the type intended to be deductible.

In conclusion, taxpayers' construction would distort the overall application of the federal estate tax. The estate tax is imposed upon the transfer of or shifting in relationships to property, and deductions are allowed under Section 2053 in recognition of the costs incident to this shifting process, so that the tax is imposed only upon the amount actually available to the heirs (in this case, the testamentary trusts). The Regulations here are designed to implement that policy. Taxpayer, on the other hand, would allow a diminution of the taxable estate for unnecessary expenses on the totally unsatisfactory basis that they had been allowed by the state probate court. Such an unreasonable result is not compelled by the language of the statute and should be rejected.

The decision of the Tax Court is correct and should be affirmed.

ARGUMENT

THE TAX COURT CORRECTLY DECIDED THAT COMMISSIONS PAID ON THE SALES OF SCULPTURE WERE DEDUCTIBLE ADMINISTRATION EXPENSES UNDER SECTION 2053 OF THE INTERNAL REVENUE CODE OF 1954 AND THE REGULATIONS THEREUNDER ONLY TO THE EXTENT NECESSARY TO PAY DEBTS, EXPENSES, AND TAXES

A. Introduction

Section 2053(a) of the Internal Revenue Code of 1954, Appendix, infra, allows a deduction, in computing the value of the estate subject to tax, for "administration expenses * * * as are allowable by the laws of the jurisdiction * * * under which the estate is being administered." The Code does not define the term "administration expense," but the Regulations provide that deductible expenses are those which are necessarily incurred in the proper settlement of the estate and not those incurred for the individual benefit of the beneficiaries of the estate. Section 20.2053-3(a), Treasury Regulations on Estate Tax (1954 Code), Appendix, infra, provides:

> The amounts deductible from a decedent's gross estate as "administration expenses" * * * are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions.

The deductibility of selling expenses is further elaborated upon in Regulations Section 20.2053-3(d)(2), Appendix, <u>infra</u>:

> Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution.

In commenting upon the predecessor of Regulations Section 20.2053-3(a) (Treasury Regulations 105 (1939 Code), Sec. 81.32), the court in <u>Commercial Nat. Bank of Charlotte</u> v. <u>United States</u>, 196 F. 2d 182, 184 (C.A. 4, 1952), stated:

> These Regulations clearly illustrate and carry into effect the general purpose of the statute to limit the allowable deductions for administrative expenses to those incurred for the benefit of the estate.

In this case, taxpayers have been allowed to deduct as administration expenses the commissions paid to Marlborough on the sales of sculpture to the extent such sales were necessary to raise enough cash to pay debts, other administration expenses, and taxes. Additional sales, however, were found (R. 88a-89a) by the Tax Court not to have been necessary either to preserve the estate or to effect distribution. Consequently, pursuant to Regulations Section 20.2053-3(d)(2), the expenses of such additional sales were not deductible. Taxpayers assail this latter determination[5/] on three bases: First, they argue (Br. 10-17) that the

5/ Taxpayers claim as an administration expense the sum of $1,602,644.67, which they allege is the full amount of sales commissions ultimately allowed by the surrogate. (Br. 8-9; but cf. Br. 7: $1,187,144.67 plus $396,400 [$396,000?]: $1,583,544.67.) Nowhere in their brief do the taxpayers identify the reasons for these additional sales, their argument resting entirely on the premise that since the surrogate allegedly allowed these additional sales commissions in subsequent accountings, such commissions are deductible under Section 2053. In the event this Court reverses the Tax Court's decision as to the deductibility of the sales commissions, taxpayers agree that a remand would be appropriate to fully substantiate the deductibility of such additional commissions.

additional sales were necessary either to prepare for additional tax liabilities or to preserve the estate and, thus, the Tax Court erred in its determination that these sales did not meet the requirements of Regulations Section 20.2053-3(d)(2); second, taxpayers argue (Br. 18-24) that the Regulations merely restate state law and therefore the action of the New York Surrogate's Court in approving the intermediate accountings was determinative as to the necessity of the sales commissions; and third, they argue (Br. 24-27) that if the Regulations are interpreted to deny a deduction for an expense which has been allowed by the state probate court, the Regulations are invalid. We submit that all of these contentions are equally unmeritorious and should be rejected.

B. The additional sales were not necessary within the meaning of the Regulations

The court below found (R. 88a-89a) that the sales of sculpture were not necessary (except to the extent that cash was needed to pay debts, other administration expenses, and taxes) either to preserve the estate or to effect distribution. It is submitted that such a determination is factual in nature, and, as such, cannot be set aside unless clearly erroneous. Commissioner v. Duberstein, 363 U.S. 278 (1960). This finding of the Tax Court, far from being clearly erroneous, is well supported by the record.

The essence of the Tax Court's determination on this issue was that, to the extent that additional cash was necessary at all, it was necessary only to provide support for the decedent's children. (R. 88a.) The terms of decedent's will leave no room for doubt that the testamentary trusts established by that

will were to be the vehicles for such support. (R. 22a-23a.) Indeed, a reading of decedent's will indicates that such trusts were to be funded by the decedent's sculpture; articles First provided only that the executors were to pay debts, expenses and taxes (R. 22a), while article Second states (R. 22a-23a), "I hereby give, devise and bequeath <u>all</u> <u>the</u> <u>remainder</u> of my property including * * * all works of art including sculpture * * * to the Trustees * * *." (Emphasis added.) Thus, as found by the Tax Court (R. 88a), "the will itself contemplated a distribution of the sculptures in kind to the trusts." Consequently, the additional sales were not incurred for the benefit of the estate but for the benefit of the trusts, and therefore the expenses of such sales are not deductible. Treasury Regulations, § 20.2053-3(a); <u>Sharpe's Estate</u> v. <u>Commissioner</u>, 148 F. 2d 179 (C.A. 3, 1945). Although article Third did give the executors and trustees a seemingly co-extensive power of sale (R. 24a), the executors could exercise this power only to the extent necessary to fulfill their limited obligations under article First. Only the trustees had the general power to sell the sculpture in order to raise cash to fulfill the purposes of the trusts. (R. 88a.) This is born out by the terms of the will wherein only the trustees were given absolute discretion in the disposal of decedent's property. (R. 24a.) Absent a power to sell beyond that which was necessary to achieve their limited obligations, the executors had no authority to make additional sales, and such sales are properly

chargeable to the trusts.[6/] Consequently, the estate is not entitled to deduct the expenses of such sales. Estate of Streeter v. Commissioner, 491 F. 2d 375 (C.A. 3, 1974).

Taxpayers continue to urge, as they did below, that the sales of sculpture were necessary in order to preserve the estate. The Tax Court was unpersuaded by this argument. (R. 88a-89a.) The evidence before the court indicated no danger that the value of the sculpture was about to collapse; indeed, the prices that were actually being realized for the sculpture indicated exactly the opposite. (Ex. 19-S, Nos. 1 and 2, Schedule A-1.) Moreover, as discussed above, after the payment of debts, expenses, and taxes, the burden of preserving the value of the sculpture devolved upon the trusts. Taxpayers offer no reason why the trustees could not have preserved that value as easily as the executors (particularly considering the fact that they were the same individuals). Finally, in this respect, it bears emphasis that deductions from the gross estate for administration expenses, as well as all other deductions under the Code, are matters of legislative grace with the burden squarely on the taxpayer to establish the amounts claimed. Burnet v. Houston, 283 U.S. 223 (1931); Helvering v. Taylor, 293 U.S. 507 (1935). Taxpayers have failed in that task.

6/ This does not mean that the surrogate was in error in approving the executors' accounts, since the surrogate's obligation to see that the decedent's estate is faithfully administered is entirely different from the Commissioner's duty to see that only those expenses which are necessarily incurred in the administration of the estate are allowed as estate tax deductions. See pp. 19-22, infra.

Finally, on appeal taxpayers urge (Br. 13-14), for the first time, that sufficient justification for additional sales of sculpture, and concomitant commissions, existed after August 7, 1969, the date on which the Commissioner asserted that the value of decedent's sculpture increased the taxable estate to $5,329,738.54, their argument being that they were entitled to anticipate the possibility that the Tax Court would accept the Commissioner's increased valuation of the decedent's sculpture, with potential resultant increased tax liability. It is clear, however, that a mere conjectural estimate of possible future liability is insufficient to support deductibility of hypothetical expenses which might be incurred in funding such contingency as an administrative expense. See Treasury Regulations on Estate Tax (1954 Code), § 20.2053-1(b)(3), Appendix, _infra_; cf. _Sharpe's Estate_ v. _Commissioner_, p. 181. The taxpayers in the instant case have never agreed with the Commissioner's determination regarding the value of the sculptures and indeed vigorously contested the issue of the sculptures' value until the Tax Court determined a value midway between the claims of the two parties.[7/] The Tax Court found that the nature of the sculpture was such, with the evidence indicating increasing sales and increasing prices, that a ready market for the sculptures existed and that any "forced sale" analogy was simply not in accord with the facts. (R. 89a.) Under these circumstances, the uncertainty

7/ Indeed, during the period May 23, 1965, through April 30, 1970, taxpayers distributed $1,448,429.44 to the beneficiaries of the estate. (R. 78a.) This is hardly consistent with their claim that the additional sales were necessary to prepare for an anticipated tax deficiency.

surrounding the question of whether the executors would ever have to pay an additional estate tax supports the Tax Court's fact finding that the sales commissions were not necessary to the settlement of the estate within the meaning of the Treasury Regulations except to the extent that additional tax liability was subsequently substantiated.8/

Accordingly, the Tax Court's finding of fact that the additional sales were not necessary within the meaning of Treasury Regulations, Section 20.2053-3(d)(2), is supported by the evidence and is, in any event, not clearly erroneous.

8/ In similar fashion the Treasury Regulations allow a deduction for attorney fees incurred in defending an asserted deficiency or in prosecuting a refund claim, even though the deduction was not claimed in the estate tax return or in the claim for refund. Treasury Regulations on Estate Tax (1954 Code), § 20.2053-3(c)(2). If the attorney were, however, to claim an attorney fee which the executor considered to be exorbitant and which the executor intended to challenge, clearly nothing in established law would permit the executor to deduct such attorney's fees until their actual amount had been established and paid. The fact that assets would have to be sold to pay the fee, once its propriety was established, is clearly not a sufficient reason to characterize such a contingent liability as "necessary," or to classify expenditures attending the sale of such assets as necessary to the administration of the estate, absent facts which establish proof that such sales were necessarily incurred "to preserve the estate." Regulations, § 20.2053-3(d)(2).

C. <u>The actions of the state probate court are not determinative in this federal tax case</u>

Taxpayers' second contention (Br. 18) is that the actions of the New York Surrogate's Court in approving the intermediate accountings in the state probate proceedings operate to preclude the Tax Court from reviewing the necessity of the additional sales of sculpture in this federal estate tax case. As mentioned above, these approved accountings listed amounts received on the sales of sculpture on the respective Schedules A-1 and noted later, in the respective Schedules J, that these amounts were net of the commissions paid to Marlborough. (Ex. 19-S, Nos. 1 and 2.) This argument is unmeritorious inasmuch as it is based upon the erroneous premise that the standards governing the allowance of expenses is the same under both New York probate law and Regulations Section 20.2053-3(d)(2).

In the first instance, a comparison of the language of the New York statute with the pertinent Regulations discloses a radical difference in coverage. Section 222 of the New York Surrogate's Court Act, relied upon by taxpayer (Br. 19), provides that an "executor * * * or testamentary trustee" may pay "expenses of administration necessarily incurred by him." Regulations Section 20.2053-3(d)(2), on the other hand, allows a deduction for the expenses of "selling the property of the estate * * * if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution." As is apparent, these two provisions differ markedly in two respects. First, the federal regulation limits deductibility

to the expenses of selling property necessarily incurred for certain specified purposes, while the New York statute is not so limited. Second, the federal regulation limits the deduction to expenses incurred by executors of estates or persons acting in the capacity of executor, while the New York statute makes no clear distinction between actions taken by executors and those taken by testamentary trustees.

New York jurisprudence has long recognized that a person nominally acting as an executor may in fact be performing the functions of a trustee. Standards for distinguishing between these two roles were enunciated as early as 1851: where the will calls for the same individual to perform both as an executor and as a trustee, the executorial duties are to take possession of the estate, "to collect the outstanding debt and sell the goods and chattels <u>so far as is necessary to the payment of the debts and legacies</u>" (emphasis added), to pay the debts and legacies, and to distribute the surplus; actions taken beyond these are taken in the capacity of trustee. <u>Drake</u> v. <u>Price</u>, 5 N.Y. 430, 432 (1851) (Judge Paige dissenting, subsequently approved by the court in <u>Hurlburt</u> v. <u>Durant</u>, 88 N.Y. 121 (1882), and <u>Johnson</u> v. <u>Lawrence</u>, 95 N.Y. 154 (1884)).

New York also gives its surrogates broad discretion to approve actions taken by an executor which could have lawfully been taken in his capacity as a trustee. <u>Matter of McDowell</u>, 178 App. Div. 243, 164 N.Y.S. 1024 (1917); <u>Matter of Robinson</u>,

155 Misc. 855, 280 N.Y.S. 687 (1935). This is in recognized contrast to cases where the executor and the trustee are different individuals. Cf. Matter of Ryer, 94 App. Div. 449, 88 N.Y.S. 52 (1904), aff'd, 180 N.Y. 532, 72 N.E. 1150 (1905). The dual role of executor and trustee, and the standards for differentiation between them, were reiterated in McDowell (178 App. Div., p. 248, 164 N.Y.S., p. 1027):

> As a general rule an executor will be deemed to be a trustee whenever a non-administrative discretionary power, such as a power of sale, is given to him, or when the duties implied are active within the meaning of this term as applied to trusts. Where an executor, after the payment of debts, legacies and expenses of administration, continues to hold the estate, he may frequently be considered as in fact holding it as a trustee * * *. (11 Ruling Case Law, 22, 23.) (Emphasis added.)

An example of these principles is present in this case. Although decedent's will clearly indicates that the testamentary trusts were to be the vehicles for the support of his two minor children (R. 22a-23a), the executors nonetheless made support payments directly from the estate (R. 78a). These payments were approved in the same accountings which taxpayers now urge as conclusive evidence that the sales of sculpture were necessary under federal law. (Ex. 19-S, Nos. 1 and 2, Schedule E.)

It is apparent, therefore, that the duty of the surrogate is to insure that the actions of the executors-trustees conform to the best interests of the estate, the trusts, and the beneficiaries. Moreover, since the sculpture would presumably have to be sold in any event in order to provide support for the minor children (a function of the trusts), there appears to be no basis upon

which any interested party could have complained about such sales.[9/] There certainly could have been no complaint that the sales should have been made by the trusts rather than the estate. Matter of McDowell, supra. Indeed, it can be presumed, from the very prosecution of this appeal, that the overall benefit to the estate, the trusts, and the beneficiaries would be greater if these sales could be characterized as necessary sales by the estate, with a consequent reduction in the federal estate tax.

In sharp contrast to the broad discretion given to the New York Surrogate's Court, the Tax Court's inquiry is specifically directed into whether the sales were necessary to pay debts, expenses, or taxes, or to preserve the estate, or to effect distribution. See Sharpe's Estate v. Commissioner, supra, p. 181:

> The work of the executor is part of the settlement of a decedent's estate. It is done for the benefit of all interested, his creditors, his next of kin, his legatees. But the carrying on of the trust is a different enterprise, not in settlement of a dead man's affairs, but for the benefit of the beneficiaries of the trust. It operates to continue the affairs of the living, not to close up those of the departed.

On this precise issue, the Tax Court ruled adversely to taxpayers with respect to the additional sales (i.e., those in excess of the sales necessary to pay debts, expenses, and taxes), and taxpayers have shown no reason why that determination should be overturned. Indeed, the fact that nothing in the evidence indicates the reasons

9/ In this respect it might be noted that the cases cited (Br. 20, fn. 10) by taxpayers illustrating the disallowance of various expenditures all involved contested accountings. The accountings in this case were uncontested.

given to the surrogate in support of the executors' claim for allowance of sales commissions lends credence to the Tax Court's conclusion that such sales were not necessary for the proper administration of the decedent's estate, insofar as the operation of Section 2053 and attendant Regulations are concerned. See Estate of Swayne v. Commissioner, 43 T.C. 190, 201 (1964). And see Treasury Regulations on Estate Tax (1954 Code), § 20.2053-1(b)(2), Appendix, *infra*. Thus, it can hardly be said that the Surrogate's Court's approval of the accountings in this case conclusively establishes the necessity of the additional sales under the federal standard; in actual fact, New York law supports the Tax Court's resolution of this issue.

Finally, even if the standards of allowability were the same under both New York and federal law, the Tax Court was still not precluded from making an independent determination of deductibility by applying the federal standard to the facts of this case. Cf. Commissioner v. Estate of Bosch, 387 U.S. 456 (1967).

D. Section 20.2053-3(d)(2), Treasury Regulations on Estate Tax, is valid

Finally, taxpayers argue (Br. 24) that, if Section 20.2053-3 (d)(2) of the Regulations is construed to disallow a deduction for an expense which has been allowed by the state probate court, the regulation is invalid. This argument, which was not addressed to the Tax Court (R. 91a), stems directly from the dissenting opinion below (R. 90a-96a) of Judge Goffe, with four judges concurring. Taxpayers have offered no cogent reason why such minority opinion should be accepted by this Court.

The standards for reviewing Treasury Regulations are well settled. The Secretary of the Treasury has broad authority to establish Regulations under Section 7805(a) of the Code, Appendix, infra, and the courts have uniformly stated that such Regulations must be sustained unless "unreasonable and plainly inconsistent" with the statute. Commissioner v. South Texas Co., 333 U.S. 496, 501 (1948). The term "administration expenses" is not defined in the statute, and it is not self-defining. Accordingly, "The regulation here in question represents an effort by the Commissioner to supply the definitions that Congress omitted" and is "prima facie proper, comporting as * * * [it does] with the ordinary understanding" of the term "administration expenses." Bingler v. Johnson, 394 U.S. 741, 749, 751 (1969). Thus, when the Commissioner exercises his authority under Section 7805(a) to prescribe "needful rules" implementing the tax statutes the Supreme Court in United States v. Correll, 389 U.S. 299, 306-307 (1967), and reiterated in Bingler v. Johnson, supra, pp. 750-751, recently defined the judicial function as follows:

> Alternatives * * * are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. 26 U.S.C. §7805(a). In this area of limitless factual variations, "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." Commissioner v. Stidger, 386 U.S. 287, 296. The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.

Moreover, "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." Helvering v. Winmill, 305 U.S. 79, 83 (1938). These Regulations have been in effect, in almost identical language, since 1919.10/ During this same period, Congress has repeatedly revised the estate tax statute, including Section 2053, without changing the provision with respect to deduction of administration expenses that concerns us here.11/ Indeed, there is evidence that Congress specifically considered the question presented in this case, and specifically reaffirmed the position taken by the Commissioner in this brief and in Treasury Regulations, Section 20.2053-3(d). As early as 1930, the Tax Court, in Jackson v. Commissioner, 18 B.T.A. 875,

10/ For corresponding prior Regulations see Treasury Regulations 37 (1918 Revenue Act), Arts. 41, 44; Treasury Regulations 63 (1921 Revenue Act), Arts. 35, 38; Treasury Regulations 68 (1924 Revenue Act), Arts. 32, 35; Treasury Regulations 70 (1926 ed.) Arts. 32, 35; Treasury Regulations 70 (1929 ed.), Arts. 32, 35; Treasury Regulations 80 (1934 ed.), Arts. 32, 35; Treasury Regulations 80 (1937 ed.), Arts. 32, 35; Treasury Regulations 105 (1939 Code), Secs. 81.32, 81.35.

11/ The predecessors of Section 2053 are as follows: Revenue Act of 1916, c. 463, 39 Stat. 756, Sec. 203; Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 403; Revenue Act of 1921, c. 136, 42 Stat. 227, Sec. 403; Revenue Act of 1924, c. 234, 43 Stat. 253, Sec. 303; Revenue Act of 1926, c. 27, 44 Stat. 9, Sec. 303 (as amended by Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 805); Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 402; Internal Revenue Code of 1939, Sec. 812(b) (26 U.S.C. 1952 ed.); Internal Revenue Code of 1954, Sec. 2053 (as amended by Sec. 2, Act. of February 20, 1946, c. 63, 70 Stat. 23; Sec. 102(c)(3), Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606; and Sec. 1, Act of August 21, 1959, P.L. 86-175, 73 Stat. 396).

acq. IX-2 Cum. Bull. 30, approved the reasonableness of Art. 32, Treasury Regulations 68, which, as noted above, p. 25, fn. 10, is the historical antecedent of the Treasury Regulations in question. Contrary to the opinion of the dissent in the instant case (R. 93a), Congress, in considering proposed amendments to Section 2053 of the Internal Revenue Code of 1954, clearly approved the validity of the Commissioner's position, for the Senate Finance Committee's Report regarding the deductibility of expenditures contained in Section 2053 states (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 472 (3 U.S.C. Cong. & Adm. News 4621, 5117-5118) that "all of the rules applicable to such items * * * [funeral expenses, administrative expenses, claims against the estate, and unpaid mortgages and indebtedness] are adopted in this section * * * [with an exception not pertinent to the point at issue]." Thus, it must be assumed that "Congress was familiar with the construction put upon the section by the Treasury and was satisfied with it." Taft v. Commissioner, 304 U.S. 351, 357 (1938).

Taxpayers do not, and indeed could not, contend that this regulation is unreasonable. As noted by the majority below (R. 89a), "The regulations appear to be directed toward safeguarding the integrity of the estate tax by making certain that administration expenses which are properly deductible will normally be limited to those which could be anticipated as being necessarily incurred and paid during the period of administration." See also Commercial Nat. Bank of Charlotte v. United States, supra;

Pitner v. United States, 388 F. 2d 651 (C.A. 5, 1967). Taxpayers contend, rather, that the restrictive language of the regulation conflicts with the language of the Code if it is construed to deny a deduction for an expense which has been allowed by the state probate court.[12/] That is, in the taxpayers' view the only condition for deductibility under the statute is the allowance of the expense by the state probate court. Although this proposition was accepted by the Sixth Circuit in Estate of Park v. Commissioner, 475 F. 2d 673 (1973), it has been accepted by no other circuit, and it is submitted that this Court should reject this argument.

Section 2053(a) allows a deduction "for administration expenses * * * as are allowable by the laws of the jurisdiction * * * under which the estate is being administered." This language is clearly separable into two parts: (1) The expense must be an "administration expense," and (2) it must be allowable by the laws of the probate jursidiction. Pitner v. United States, supra. The challenged Regulations in this case do no more than define the term "administration expenses" as that term is used in the statute (and, to repeat, taxpayer does not challenge its

12/ Schmalstig v. Conner, 46 F. Supp. 531 (S.D. Ohio, 1942), relied upon by taxpayers (Br. 25), does not support this proposition. In that case the Government had contended that certain attorney fees were not allowable under Ohio law; the court, upon reviewing the Ohio authorities, concluded that they were allowable. Indeed, the language from the Schmalstig opinion quoted by taxpayers to the effect that there are two restrictions imposed by the statute, i.e., that the expense must both be allowable by the probate jurisdiction and be within the class of administration expenses, supports the Government's position in this case. Taxpayers apparently recognize this when they state (Br. 25) that "Congress imposed only two restrictions." (Emphasis added.)

reasonableness, nor did the dissenters below or the Sixth Circuit in Estate of Park). Taxpayers, however, would lump these two criteria together to allow the state probate court to determine not only what is "allowable" under its own law, but also what is an "administration expense" under federal law, thereby ousting the Secretary and the federal courts from jurisdiction to protect the federal interest in this area. Such a position is untenable. First, as discussed fully, supra, pp. 19-23, the state probate court, in approving an accounting, may allow an expense on a wide variety of bases which are totally unrelated to the federal revenue. For example, New York courts allow executors to use the assets of the estate to pay for certain personal expenses of the friends and relatives of the decedent. In Matter of Morawetz, 35 Misc. 2d 762, 231 N.Y.S. 2d 1000 (1962), the surrogate approved an accounting wherein the executor had paid the expenses of certain friends and relatives to travel from New York to Baltimore to view the interment of the decedent. Although the assumption by the estate of such personal obligations of others would clearly not be deductible,[13] under taxpayers' theory the mere fact that the expenses were approved by the surrogate would be determinative.

Second, it is elementary that, while state law creates interests in property, federal law determines the extent to which such state-created interests are taxable under the federal statute regardless of the particular label the state may put on such interests.

13/ If such expenses were deductible, the effect would be to confer a tax-free gift upon the recipients. Such is not permissible. United States v. Stapf, 375 U.S. 118 (1963).

Morgan v. Commissioner, 309 U.S. 78 (1940). This principle has its corollary with respect to deductions. That is, while state law may allow an expense in probate and label it an "administration expense," federal law must determine whether the particular expense was of the type intended to be deductible as an "administration expense" under the federal statute. United States v. Stapf, 375 U.S. 118 (1963), citing Morgan v. Commissioner, supra. Thus, in Ballance v. United States, 347 F. 2d 419 (C.A. 7, 1965), although Illinois law regarded the federal estate tax as an administration expense, the court stated (p. 421) "It would appear absurd to contend the estate tax itself is deductible as an expense of administration in arriving at the amount of such tax." See also Estate of Joslyn v. Commissioner, 74-2 U.S.T.C., par. 13,012 (C.A. 9, June 24, 1974), wherein the issue of the deductibility of certain selling expenses was remanded to the Tax Court to determine if they were within the purview of Section 2053, although such expenses had been allowed by the state probate court.[14/]

Finally, taxpayers' construction of the statute, with the resulting invalidity of these Regulations, would defeat the overall purpose of the estate tax. The tax is levied, not upon the property transferred, but upon "the transfer of or shifting in relationships to property at death." U. S. Trust Co. v. Helvering, 307 U.S. 57, 60 (1939). The tax is "measured by the value of the interest

14/ While the Government agrees with this portion of the decision in Joslyn, we do not agree with that part of the court's opinion dealing with the "double deduction" issue.

transferred" (Chase Nat. Bank v. United States, 278 U.S. 327, 334 (1929)), and is imposed on the net or taxable estate, the gross estate less exemptions and deductions (Sec. 2051, Appendix, infra). Deductions for expenses are allowed in an attempt to limit the net or taxable estate "to the amount actually available to the heirs" (in this case, the testamentary trusts), since it would be manifestly unjust to impose the tax on the value of the interest available to the trusts without taking into account the expenses incurred by shifting the relationships to the property transferred. See Lowndes and Kramer, Federal Estate and Gift Taxes (2d ed.), § 2.4, p. 7. It would defeat this attempted fairness, however, if the provisions of the Code were to be interpreted in a manner which allowed an unrealistic distortion of the value of the estate upon which the tax is imposed and which is available for distribution to the trusts. The Regulations in issue here are designed to prevent such distortions by limiting the deductibility of expenses to those necessarily incurred in this process of shifting relationships. As discussed above, beyond the extent necessary to pay debts, expenses, and taxes, it was not necessary for taxpayers to sell this sculpture, and incur the expenses incident thereto, in order to transfer the sculpture to the testamentary trusts. The full value of this sculpture, unimpaired by sales commissions, was available to the trustees, in whom was vested sole discretion to sell or not to sell in order to carry out the purposes of the trusts. (R. 88a.) It is this value which is properly subject to tax.

It is submitted, therefore, that taxpayers' construction of the statute, which would render the Regulations invalid and would allow a deduction for expenses not incurred as part of the necessary administration of the estate solely on the totally unsatisfactory basis that the expenses had been allowed in a state probate accounting, is neither required by the language of the statute itself nor compatible with its purposes, and should be rejected. As the Fifth Circuit said in Pitner v. United States, supra, p. 659, "When * * * state law fails in adequately representing the interest of the federal government, a framework still exists grounded in federal law defining the limits to which an expense may go and still be considered deductible for federal estate tax purposes." And see Estate of Joslyn v. Commissioner, supra, p. 8859-38, fn. 7.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made upon opposing counsel by mailing two copies thereof to each on this 21st day of August, 1974, in an envelope, with postage prepaid, properly addressed to each of them, respectively, as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 2051. DEFINITION OF TAXABLE ESTATE.

For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the exemption and deductions provided for in this part.

SEC. 2053. EXPENSES, INDEBTEDNESS, AND TAXES.

(a) General Rule.--For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts--

(1) for funeral expenses,

(2) for administration expenses,

(3) for claims against the estate, and

(4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,

as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

* * *

SEC. 7805. RULES AND REGULATIONS.

(a) Authorization.--Except where such authority is expressly given by this title to any person than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

(b) Retroactivity of Regulations or Rulings.--The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

(c) Preparation and Distribution of Regulations, Forms, Stamps, and Other Matters.--The Secretary or his delegate shall prepare and distribute all the instructions, regulations, directions, forms, blanks, stamps, and other matters pertaining to the assessment and collection of internal revenue.

Treasury Regulations on Estate Tax (1954 Code) (26 C.F.R.):

§ 20.2053-1 Deductions for expenses, indebtedness, and taxes; in general.

*   *   *

(b) Provisions applicable to both categories--* * *

(2) Effect of court decree. The decision of a local court as to the amount and allowability under local law of a claim or administration expense will ordinarily be accepted if the court passes upon the facts upon which deductibility depends. If the court does not pass upon those facts, its decree will, of course, not be followed. For example, if the question before the court is whether a claim should be allowed, the decree allowing it will ordinarily be accepted as establishing the validity and amount of the claim. However, the decree will not necessarily be accepted even though it purports to decide the facts upon which deductibility depends. It must appear that the court actually passed upon the merits of the claim. This will be presumed in all cases of an active and genuine contest. If the result reached appears to be unreasonable, this is some evidence that there was not such a contest, but it may be rebutted by proof to the contrary. If the decree was rendered by consent, it will be accepted, provided the consent was a bona fide recognition of the validity of the claim (and not a mere cloak for a gift) and was accepted by the court as satisfactory evidence upon the merits. It will be presumed that the consent was of this character, and was so accepted, if given by all parties having an interest adverse to the claimant. The decree will not be accepted if it is at variance with the law of the State; as, for example, an allowance made to an executor in excess of that prescribed by statute.

On the other hand, a deduction for the amount of a bona fide indebtedness of the decedent, or of a reasonable expense of administration, will not be denied because no court decree has been entered if the amount would be allowable under local law.

(3) Estimated amounts. An item may be entered on the return for deduction though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate. If the amount of a liability was not ascertainable at the time of final audit of the return by the district director and, as a consequence, it was not allowed as a deduction in the audit, and subsequently the amount of the liability is ascertained, relief may be sought by a petition to the Tax Court or a claim for refund as provided by sections 6213 (a) and 6511, respectively.

* * *

Treasury Regulations on Estate Tax (1954 Code) (26 C.F.R.):

§ 20.2053-3 Deduction for expenses of administering estate.

(a) In general. The amounts deductible from a decedent's gross estate as "administration expenses" of the first category (see paragraphs (a) and (c) of § 20.2053-1) are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. * * *

* * *

(d) Miscellaneous administration expenses.
* * *

(2) Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution. * * *